CORE
Metadata, citation and similar papers at core.ac.uk
Provided by eGrove (Univ. of Mississippi)

University of Mississippi
eGrove

Haskins and Sells Publications
Deloitte Collection

1923

Padded inventories

Anonymous

Follow this and additional works at: https://egrove.olemiss.edu/dl_hs
Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Haskins & Sells Bulletin, Vol. 06, no. 09 (1923 September), p. 69-71

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Haskins and Sells Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

date and amount of the next maturing installment or installments, if the situation requires the latter, every purpose appears to be served. The reader is on notice as to the time when the installment will mature, the facts have been stated, and even though sharp classification has been purposely avoided, even the statisticians who may have occasion to use the figures are in a position to adjust the current liabilities or not, as their judgment or scheme of use may dictate.

Padded Inventories

NOT long since the daily papers contained reference to a report filed in the Federal Court by the receivers for a silk concern in which, according to the newspapers, it set forth that "the inventory of the corporation was overstated by a sum in excess of $1,250,000, and that the overstatement was concealed from the accountants and appraisers by the creation of false records for the purpose of deceiving the bankers."

Newspaper reports are not needed to recall other instances where inventories have been used for purposes of deception, to conceal losses, inflate profits, and generally produce favorable results. During the past three or four years conditions have been ripe for this sort of thing, due to the marked fluctuations in price levels and the readjustments occasioned by economic influences.

The subject of inventories is one which all accountants who are thoughtful and sensitive to the risk involved need to approach with some fear and trembling. Granting, however, that the accountant takes his professional life in his hands, so to speak, when he approaches a situation in which inventories are involved, there is still no reason, apparently, why he should not make use of such common sense as he has without relying solely on the somewhat perfunctory technique usually employed in verification procedure.

The story of inventory requirements from an accounting point of view is old and worn, but, perhaps, like the oft-told tale, it becomes so commonplace that it is accepted as a matter of course and forthwith disregarded. The word *inventory* implies the physical existence of materials or goods. This existence, obviously, is prerequisite to value. Further, the term definitely means a counting, listing and valuing of goods. The verification of an inventory then involves several questions: (1) becoming satisfied as to the existence of the goods; (2) that they were accurately counted and listed; (3) that the prices used in valuation were proper; and (4) that the mathematical computations necessary to arrive at a total were correct.

On the first point evidence is frequently impossible beyond the attestation of persons who took or supervised the physical count, except in those somewhat rare instances where the accountants were in charge of such work. Too frequently no physical inventory is taken and the quantities are drawn from the book records. There is here, of course, an added question as to whether or not the balances on the stock records reasonably represent the goods in existence.

As to the counting and listing the accountant is likewise dependent on the word of others, except as he may have the opportunity to test the schedule from original memoranda made in the case of a physical inventory when the count was taken. Prices used in valuation, however, are usually at his disposal, and it is in this particular, usually, that he may render most intelligent service. The basis of valuation is too well established to call for much question. Cost or market, whichever was lower at the date of inventory, has come to be usually accepted, save only in certain industries where the practice thereof is to use sales prices. The investigation of inventories for obsolete, unsalable, or scrap material naturally calls for considerable care, and it is frequently necessary to be guided somewhat by the judgment of others as to the values thereof.

In the matter of mathematical computations the accountant usually has at his command ample opportunity for investigation, and the opinion is ventured that more stress is placed on this phase of the work generally than is warranted. Unfortunately, instead of reviewing the whole inventory carefully before beginning work, the accountant is too prone to begin routine checking, failing to distinguish between the items which are important and those which are unimportant.

It is not without the scope of reason, in so far as the accountant is concerned, to expect that in addition to applying routine methods of verification intelligently he will use some measure of common sense in his work. This requires of him that he will consider first the value placed on the inventory in relation to the total values assigned to the company's assets, and plan his work in accordance with the importance of the inventory as indicated by this relation. There is nothing to prevent him from inspection of such stock of goods and materials as is on hand at the time he begins his investigations and from developing, by questioning responsible employes and investigating various records, subsidiary and otherwise, information which will give him some check on the situation at the date under consideration. Most accountants recall instances where personal inspection has brought to light large quantities of material, the condition of which at the time of inspection would have made it impossible to have included such material in an inventory previously taken, at cost or market values. By measurement, count, or even rough estimate and subsequent calculation, the accountant in these instances would have been justified in excluding such materials from the inventory except at scrap values.

The verification of prices need not be restricted to the company's records. Independent sources of data, such as catalogues, price lists, trade publications, and the now numerous published statistical tables, are available to the accountant who is aware of these sources as a means of independent verification.

Preceding all this the intelligent accountant has at his command common sense methods of judging the reasonableness of the inventory results. His knowledge of accounting tells him that the two elements of sales price are profit and cost; that the difference between sales and net profit, having consideration for extraneous earnings, is selling cost; that the difference between sales and gross profit is manufacturing cost. Records are usually available from which average or reasonable gross profit may be determined which, when taken out of the sales, will indicate the cost for the period under consideration. Having regard to turnover and fluctuations in price level, the accountant of average intelligence finds little difficulty in obtaining a general check on inventories. Granting that this test is not conclusive, it nevertheless brings to light immediately illogical or improper valuations of inventories, and the chances are that it will point the way to the discovery of trickery, concealment, or manipulation in inventory matters.

It is inconceivable that an installment house could continually inflate inventories by taking in goods repossessed without relieving the accounts receivable correspondingly, were a test of this character applied. It is likewise hard to believe that any inventory could be padded to the extent of over a million dollars had the accountants investigated the matter with some perspective instead of having gotten so close to the details as to have had the true situation obscured. Technical procedure, unseasoned by common sense, is not likely to discover padded inventories, particularly where there is a deliberate attempt at concealment and falsification of records. A little common sense at times is worth more than all the technical procedure in the world.

Observations of a Junior Assistant

THE following comments are the expressions of a man on the staff who started thinking about his work when his responsibilities were meagre. There is perhaps nothing new in the observations themselves beyond the fact that they bring out some of the points concerning procedure in a phase of public accounting work which is frequently passed over somewhat casually as being of minor importance. Faithfulness in the little things, in thought as well as deed, has brought to this man enlarged responsibilities and more important work. He is now an in-charge accountant.

It is often the case that our count of petty cash is simply perfunctory. We ascertain from the general ledger that there should be a certain amount of cash in the imprest fund. We then set about to verify the amount. Our one point in view is to see either the cash, cash items, or proper vouchers.

In counting the cash and cash items we find little difficulty. It is in the case of proper vouchers that we at times fail to glean their import. In our haste or anxiety to prove the correctness of the fund, we simply note the amount of the voucher, that it is properly signed or supported by an invoice, and then pass on to the next voucher. Perhaps we are negligent about glancing at the date of the voucher; but more important, we should question the propriety of the inclusion of all the items in petty cash.

The following example may serve to better illustrate these points:

We were making an audit for the six months ended March 31, 1922. The engagement was started in April, 1922. The petty cash fund amounted to $300. Upon counting the fund it was found to consist of approximately $150 in cash, and vouchers bringing the amount up to $300. The dates of the vouchers ran as far back as December, 1921, and only a few small amounts were applicable to the period subsequent to March 31, 1922. The cashier was asked if it was not usual to reimburse the imprest fund and distribute the expense at the end of the fiscal period. She replied that they had no special time for reimbursing the imprest fund, and that she was of the opinion that similar conditions had existed on previous audits; however, no questions had been raised about the matter. Undoubtedly, if such conditions had previously existed the petty cash count had not disclosed this fact. Otherwise the situation would have been corrected by the one reviewing the report. Too often we show but one amount for vouchers, omitting all detail.

In the above case, after considering the size of the engagement and our certificate, it was deemed advisable to insist on the proper distribution of the $150 to the expense accounts affected.

In verifying the petty cash of a publishing institution in April, 1922, two receipts for funds deposited with the post office